Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM: CTM:LN:TL-N-2558-00
LWKuo

date: OCT 18 2000

to: Chief, Examination Division, Southern California District
Attn: Ed Haught, Acting Group Manager, LMSB
Calvin Mahi, Revenue Agent, LMSB

from: Associate Area Counsel (LMSB), Laguna Niguel

subject: [redacted]

DISCLOSURE STATEMENT

THIS ADVICE CONSTITUTES RETURN INFORMATION SUBJECT TO I.R.C. § 6103. THIS ADVICE CONTAINS CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND IF PREPARED IN CONTEMPLATION OF LITIGATION, SUBJECT TO THE ATTORNEY WORK PRODUCT PRIVILEGE. ACCORDINGLY, THE EXAMINATION OR APPEALS, RECIPIENT OF THIS DOCUMENT MAY PROVIDE IT ONLY TO THOSE PERSONS WHOSE OFFICIAL TAX ADMINISTRATION DUTIES WITH RESPECT TO THIS CASE REQUIRE SUCH DISCLOSURE. IN NO EVENT MAY THIS DOCUMENT BE PROVIDED TO EXAMINATION, APPEALS, OR OTHER PERSONS BEYOND THOSE SPECIFICALLY INDICATED IN THIS STATEMENT. THIS ADVICE MAY NOT BE DISCLOSED TO TAXPAYERS OR THEIR REPRESENTATIVES.

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Pursuant to our National Office's recommendation, we are supplementing our memorandum dated June 19, 2000 concerning the deductions claimed by [redacted] on its [redacted] tax return for certain legal, professional and accounting fees. In our June 19, 2000 memorandum, we concluded that, under the principles of I.R.C. §§ 162(a) and 263(a), [redacted] was not entitled to deduct those fees in [redacted] because it had incurred the fees in the reorganization or restructuring of the corporate entity for the benefit of future operations and therefore, should have capitalized the fees in question.

But it appears that some of the fees may not have been incurred in [redacted] which would preclude capitalization as well as deduction until the liability for the fees is fixed (the "all-events" test) and economic performance has incurred (the economic performance test). *See* I.R.C. § 461; Treas. Reg. §§ 1.446-1(c)(1)(ii)(A) and (B). Under the "all events" test, an accrual-method taxpayer incurs a fee when all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. I.R.C. § 461(h)(4); Treas. Reg. §§ 1.461-1(a)(2) and 1.446-1(c)(1)(ii). Under the economic performance test, the "all events" test is considered met only if economic performance with respect to the liability has occurred. *Id.* I.R.C. § 461(h); Treas. Reg. § 1.461-4(a). In [redacted]'s case (where [redacted]'s liability arises from the provision of services to it), economic performance occurs as the legal, professional or accounting services are provided to it. I.R.C. § 461(h)(2); Treas. Reg. § 1.461-1(d)(1).

Under these two tests, it appears that [redacted] may not have incurred the following expenses in [redacted]:

1. Most of the $[redacted] transaction fee due under the [redacted] agreement.

There are three components of this transaction fee:

(1) the $[redacted] non-refundable portion of the fee paid upon execution of the [redacted] agreement on [redacted].

This component was incurred in [redacted]. The liability was fixed in [redacted] because, under the terms of the agreement, the amount was predetermined and the last event necessary to fix the liability (*i.e.*, the execution of the agreement on [redacted] had occurred in [redacted]. *See* U.S. v. General Dynamics Corp., et al., 481 U.S. 239 (1987). Economic performance had occurred by the end of [redacted] because all services were to be provided within the [redacted]-month period beginning [redacted].

(2) the "guaranteed" $[redacted] transaction fee, if [redacted] had refused a bona fide offer, obtained by [redacted] to enter into a Sales transaction for at least $[redacted] in aggregate consideration.

If [redacted] had obtained such a bona fide offer that [redacted] refused, all before the end of [redacted] then this component was incurred in [redacted]. The liability would have been fixed in [redacted] because, under the terms of the agreement, the amount was predetermined and the last event necessary to fix the liability (*i.e.*, [redacted]'s refusal of such a bona fide offer obtained by [redacted] would have occurred in [redacted]. *See* General Dynamics, 481 U.S. 239. Economic performance would have occurred by the end of [redacted] because [redacted] would have performed all services required to obtain such a offer,

including the service of obtaining the offer, by the end of [redacted]

If [redacted] had not obtained such a bona fide offer before the end of [redacted], then this component was not incurred in [redacted] because neither the last event necessary to fix the liability (*i.e.*, [redacted]'s refusal of such a bona fide offer obtained by [redacted], or economic performance would have occurred by the end of [redacted] You may want to obtain additional information so we can whether the "all events" test was met or whether economic performance occurred, in [redacted]

(3) the remaining $[redacted] (or $[redacted] if the $[redacted] "guaranteed" transaction fee was due) transaction fee.

This component was not incurred in [redacted] The liability was not fixed in [redacted] because the last event necessary to fix the liability (*i.e.*, the consummation of the Sales transaction) did not occur until [redacted]. *See* U.S. v. General Dynamics Corp., et al., 481 U.S. 239 (1987). If [redacted] had not consummated a sale then [redacted] would not have become liable to pay this additional amount, at all.

2. $[redacted] reimbursement of [redacted]'s out-of pocket expenses.

This expense was incurred in [redacted]. The liability was fixed in [redacted] because all events that established the fact of the liability - *i.e.*, that [redacted] incurred the certain costs, [redacted] asked [redacted] for reimbursement and [redacted] reimbursed [redacted] - had occurred by the end of [redacted] and the amount of the liability was established in [redacted] Economic performance had occurred by the end of [redacted] because these out-of pocket expenses were incurred while [redacted] performed services for [redacted] during [redacted]

3. $[redacted] accounting fees

It appears that $[redacted] of this amount, payable to [redacted] was incurred in [redacted] because the associated services to be performed by [redacted] (*i.e.*, the audit of [redacted]'s [redacted] financial statements) could have only occurred in [redacted] Since there is insufficient information concerning the nature of the $[redacted] amount, we cannot determine whether the "all events" test had been met or whether economic performance has occurred, in [redacted] or another year. You may want to obtain additional information so we can make this determination.

If [redacted] did not incur the above expenses in [redacted] then [redacted] could have not claimed a deduction for these expenses in [redacted]. In addition, [redacted] would not be able to capitalize these expenses in [redacted] As discussed in our previous memorandum, the principal

difference between a deduction and an item that must be capitalized and amortized is the timing of the recovery of the expenditure. But before you reach the question of deducting or capitalizing an expenditure, the expenditure in question must have been incurred, *i.e.*, passed the "all events" test and economic performance test.

If you have any questions, please call Lisa Kuo at (949) 360-2689. We are closing our file at this time.

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N-~~2291~~-00
GHClaser 2553

date: JUN 16 2000

to: Chief, Examination Division, Southern California District
Attn: Ed Haught, Acting Group Manager, SP 1413
Calvin Mahi, Revenue Agent, SP 1413.

from: District Counsel, Southern California District, Laguna Niguel

subject: [redacted]

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I. SUMMARY

This memorandum is in response to your Memorandum dated April 18, 2000, requesting advice concerning certain potential issues you believe you have identified during the Examination of [redacted], an S Corporation. The issues you have asked our opinion on are set forth in more detail below.

II. ISSUES

1. Whether, pursuant to section 461(h) of the Internal Revenue Code ("Code"), certain Legal and Professional expenses accrued by [redacted] during its [redacted] taxable year, but not paid until the [redacted] taxable year, attributable to the sale of [redacted] (totaling $[redacted] are currently deductible as an ordinary and necessary business expense on [redacted]'s Form 1120"S" for the [redacted] tax year.

2. Whether, pursuant to section 461(h) of the Code, certain Accounting Fees accrued by [redacted] during its [redacted] taxable year, but not paid until the [redacted] taxable year, attributable to the sale of [redacted] (totaling $[redacted] are currently deductible as an ordinary and necessary business expense on [redacted]'s Form 1120"S" for the [redacted] tax year?

3. Whether [redacted] should be allowed as a current deduction all of the selling expenses claimed on its Form 1120"S" for the [redacted] year relating to the sale of [redacted] as referenced in Issues 1 and 2, above, or whether such expenses should be "bifurcated as part ordinary and part capital," as requested by the Taxpayer.

III. SHORT ANSWERS

1. and 2. No. These issues do not involve a section 461(h) economic performance matter. Rather they involve a determination under sections 263(a) and 162(a) whether the professional, legal, and accounting fees incurred by [redacted] relating to the sale of [redacted] are currently deductible or whether such expenses should be capitalized. Based upon INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 112 S. Ct. 1039 (1992) ("INDOPCO") and its progeny, we believe the facts and circumstances of this matter support a conclusion that all of the legal, professional, and other costs incurred directly with, or incidental to, the sale of [redacted]'s assets, must be capitalized under section

263(a), because these expenses were incurred in the reorganization or restructuring of a corporate entity "for the benefit of future operations." INDOPCO, supra at 90. Thus, the entire $[redacted] in legal and professional fees paid to [redacted] and the entire $[redacted] in accounting fees paid to [redacted] in connection with the sale of [redacted]'s assets are not currently deductible as ordinary and necessary business expenses. Instead, they must be capitalized as part of [redacted] s selling expenses thereby reducing the total capital gain resulting from the installment sale.

3. No. Based on the rationale set forth in response to Issue Nos. 1 and 2, above, all of the selling expenses attributable to the disposition of [redacted] pursuant to the Sales Transaction are capital in nature and thus non-deductible. Furthermore, although the Taxpayer's argument concerning the "bifurcation" of the selling expenses between "part capital and part ordinary" is well taken, based on the facts and materials you have provided us there is no evidence establishing the Taxpayer's entitlement to any such apportionment.

IV. **FACTS**

A. General

During the years at issue, [redacted] was involved in the manufacture of [redacted] for wholesale distribution. Gross sales for [redacted] in [redacted] were approximately $[redacted].

[redacted] was incorporated on [redacted] and elected "S" corporation status almost immediately thereafter, on [redacted]. As of [redacted], [redacted] had [redacted] shareholders, as follows:

Shareholder Name	Interest in Disquise
[redacted]	[redacted]

[redacted] used the accrual method of accounting and had a fiscal year ending December 31. [redacted] late-filed its Form 1120"S" for the [redacted] year on or about [redacted]. [redacted] timely filed a Form 1120"S" for its shortened [redacted] taxable year

(covering the period [redacted] through [redacted]. Both of [redacted]s [redacted] and [redacted] Forms 1120"S" were prepared by [redacted] As of [redacted], [redacted] had the same shareholders (and each shareholder held the same interest in [redacted] as of [redacted].

B. Asset Sale of [redacted]

1. The [redacted] Agreement

On [redacted] [redacted] entered into an agreement with [redacted] ("the "[redacted] Agreement.") whereby [redacted] retained [redacted] to serve as its "exclusive" financial advisor for a period of [redacted] months, with respect to:

- The sale, repurchase, redemption, or similar transaction involving the assets, business, or stocks of [redacted];
- Any merger or consolidation involving [redacted] other than transactions in which [redacted] acquires another business (and in connection with which the current shareholders of [redacted] maintain an [redacted]% equity interest (on a fully diluted basis)); or,
- Any recapitalization of [redacted].[1]

Under the terms of the [redacted] Agreement, [redacted] was to provide the following services to [redacted]:

(1) The analysis and evaluation of the business, properties, and operation of [redacted];

(2) The preparation of a Confidential Information Memorandum for distribution and presentation to potential purchasers;

(3) Assistance in identifying and screening prospective purchasers and preparation of a list of such prospective purchasers; and,

(4) Assistance in soliciting and evaluating proposals from prospective purchasers and negotiating a purchase and sale agreement with any final prospective

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[1] Hereinafter these three items will individually and collectively be referred to as the "Sale Transaction."

purchaser.

In connection with the services described above, [redacted] agreed to pay [redacted] the following compensation:

(1) A non-refundable fee of $[redacted] for financial advisory services, which fee was to be credited against the ultimate transaction fee; and,

(2) In the event of a Sales Transaction occurring during the term of the [redacted] Agreement or after its termination[2], a Transaction Fee equal to the aggregate of [redacted]% of the first $[redacted] of aggregate consideration; [redacted]% of the next $[redacted] of aggregate consideration; and [redacted]% of the aggregate consideration in excess of $[redacted].

Furthermore, in the event that [redacted] obtained a bona fide offer to enter into a Sale Transaction for at least $[redacted] but that offer was subsequently turned down or refused by [redacted] and/or its shareholders, [redacted] was still guaranteed a transaction fee of $[redacted].

2. The "Sales Transaction"

On [redacted], [redacted] made an offer to acquire "a majority" of stocks of [redacted] from its shareholders.[3] The terms of this offer

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[2] As part of its provisions, the [redacted] Agreement provides that [redacted] will be entitled to this transaction fee if,

[redacted]

[3] We note that the copy of the [redacted] Offer submitted for us to review has not been countersigned by the Shareholders of [redacted]. We recommend that the examiner secure a fully executed copy of this document. Further, we have been advised that the

called for [redacted] ("Buyer") and the shareholders of [redacted] ("Sellers") to form a new corporation called "Newco."[4] In turn, Newco was to then purchase all [redacted]% of [redacted]'s common stock from its shareholders for $[redacted] in cash, plus the issuance of a $[redacted] note, in a section 338(h)(10) transaction.[5] Newco further agreed to make contingent payments to the shareholders of [redacted] of up to an additional $[redacted] over a period not to exceed [redacted] years, to the extent that Newco's actual ordinary earnings before EBIDTA (i.e., interest expense, interest income, income taxes, depreciation, amortization, and management fees ("earn-out")) exceeded certain target levels during the period [redacted] through [redacted].

As part of the overall offer package, [redacted] also agreed to: (a) allow the shareholders of [redacted] the opportunity to invest up to [redacted]% of Newco's equity securities on a "pari passu" basis with [redacted]; (b) allow other members of [redacted]'s management team (to be specifically designated by the shareholders of [redacted] the opportunity to invest, pari passu

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sale in question ultimately involved a sale of assets and not stock, as referenced in the [redacted] offer, i.e., Letter of Intent. This normally does not change the conclusion set forth in this memorandum.

[4] Newco was to be capitalized with a minimum of $[redacted] in equity securities to be provided by [redacted], the Sellers, and other members of [redacted]'s management. The balance of the funding of Newco was to come from $[redacted] of [redacted] notes provided by institutional investor, $[redacted] ($[redacted] at closing) of senior debt provided by bank lenders, and a new factoring arrangement similar to that currently used by [redacted]. [redacted] also indicated that it was prepared to invest up to an additional $[redacted] of equity capital in Newco after the initial acquisition but that [redacted] would have contractual preemptive rights with respect to any such additional investment.

[5] The Note was to bear interest at [redacted]% per annum, was to be payable in full on the [redacted] anniversary of the closing date, and was to be subordinated to all senior and subordinated debt provided by third parties. Interest on the Note was payable on each anniversary of the closing date. However, in the event that (i) Newco's earnings after closing were at least equal to the earn-out target and (ii) one or more the Sellers is terminated without cause after closing, Newco was obligated to repay the portion of the Note held by that Seller or those Sellers at time of termination.

with [redacted], in equity securities of Newco; (c) use "reasonable efforts to afford to [the shareholders of [redacted] the maximum available tax deferral on their equity investment in Newco"; (d) permit the shareholders of [redacted] to name two representatives to Newco's board of director, which was to be controlled by [redacted] and (e) allow the senior management team already in place at [redacted] to retain the same titles and perform the same duties at Newco following the closing of the Sale Transaction. The proposed offer was also contingent upon the satisfactory completion of a thorough business review by [redacted] and upon negotiation and execution of a mutually satisfactory definitive binding agreement by [redacted] ("Definitive Purchase Agreement")[6] and the deal was to be consummated by [redacted].

The Sales Transaction was apparently consummated on, or about, [redacted]. After the Sales Transaction, the successor corporation was named [redacted]. Between $[redacted] - $[redacted] in assets were transferred to Newco/[redacted] from [redacted] as a result of the Sales Transaction.[7] Following the Sales Transaction [redacted], [redacted] and [redacted], former officers and the majority shareholders of [redacted], were retained to participate in the management of [redacted] and each of these individuals continued to hold a minority interest in [redacted].

3. Expenses Deducted by [redacted] on its Form 1120"S" for the [redacted] Year relating to the Sales Transaction.

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[6] The Definitive Purchase Agreement was not presented to us for review. In the event the examiner does not have this document, we strongly recommend that it be procured. We also note that in the documents provided by the examiner for review, reference is made to documents called the "Merger Agreement" and the "Credit Agreement." These documents were not provided to us for review. Again, in the event the examiner does not have these documents we strongly recommend that they be procured.

[7] There appears to be some sort of a dispute between [redacted] and [redacted] as to what liabilities were actually assumed by the buyer following the Sales Transaction. On a Form 8594, "Asset Acquisition Statement Under Section 1060," [redacted] reported that $[redacted] (this figure included certain liabilities assumed by [redacted]/Newco) in assets had been transferred pursuant to the Sales Transaction to Newco/[redacted]; a similar Form 8594, filed by [redacted] reports that $[redacted] in assets were transferred as a result of the Sales Transaction.

a. Legal and Professional

On its Form 1120"S" for the [redacted] taxable year, [redacted] claimed deductions for legal and professional fees in the amount of $[redacted]. Of this amount, $[redacted] related to payment of the following expenses to [redacted]:

February Advisory Fee	$ [redacted]
February Out of Pocket Expenses	
March Out of Pocket Expenses	
May Out of Pocket Expenses	
June Out of Pocket Expenses	
July Out of Pocket Expenses	
September Out of Pocket Expenses	
October Out of Pocket Expenses	
November Out of Pocket Expenses	
December Acquisition Fees	
Total	$ [redacted]

On [redacted], [redacted] submitted an invoice to [redacted] in his purported capacity as an officer of either [redacted] or [redacted] (the evidence you have provided us is unclear on this point), seeking payment of the $[redacted] transaction fee due to [redacted] pursuant to the [redacted] Agreement (actual Fee was $[redacted] less the $[redacted] non-refundable fee already paid in [redacted]). This fee was paid by a check drawn upon [redacted]'s [redacted] account [redacted] which posted on [redacted].[10] Starting [redacted], all of the economic benefits and liabilities of [redacted]'s [redacted] account number [redacted] were transferred to, and assumed by, [redacted].

b. Accounting Fees - [redacted]

On its [redacted] Form 1120"S", [redacted] deducted $[redacted] in accounting charges. At least $[redacted] of this amount appear to be accrued expenses for accounting fees payable to [redacted]. Bank records indicate that [redacted] or [redacted] paid $[redacted] to [redacted] in [redacted] via check number [redacted] [redacted]'s

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[8] The Accounts Payable Ledger of [redacted] for the period ending [redacted], reflects an account payable of $[redacted] to [redacted].

[9] The letter is addressed to [redacted] as President of [redacted].

[10] The check (check number [redacted]) is dated [redacted], and appears to have been signed by [redacted].

general ledger recorded this $[redacted] disbursement to [redacted] as an "Accrual of Acquisition Fees," debiting its accounts payable and crediting its cash account.

In the agent's file there is an Engagement Letter issued by [redacted] to [redacted], dated [redacted]. According to this letter, [redacted] was retained by [redacted] to audit the balance sheet (and the related statement of income and retained earnings and cash flows) only of [redacted] for the year ending [redacted].[11]

V. LAW

Income tax deductions are a matter of legislative grace, and the burden of clearly showing the right to the claimed deduction is on the taxpayer. See Rule 142(a); INDOPCO, supra at 84. Moreover, deductions are strictly construed and allowed only "as there is clear provision therefor." Id. at 84 (quoting New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934)).

The principal difference between a deduction and an item that must be capitalized and amortized is the timing of the recovery of the expenditure. The Supreme Court in INDOPCO, supra at 83-84, explained:

> The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise.
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> * * *
>
> Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.

To qualify as an allowable deduction under section 162(a), an item must (1) be paid or incurred during the taxable year, (2) be for carrying on any trade or business, (3) be an expense, (4) be a necessary expense, and (5) be an ordinary expense.

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[11] There is no other documentation currently in the agent's file which discusses the nature of these expenses.

Commissioner v. Lincoln Sav. & Loan Association, 403 U.S. 345, 352 (1971); see also INDOPCO, supra at 86. An expense that creates a separate and distinct asset, however, is not "ordinary." See Commissioner v. Lincoln Sav. & Loan Association, supra at 354; see also Norwest Corporation and Subsidiaries v. Commissioner, 112 T.C. 89, 97 (1999) (and other cases cited therein). Nor is an expense "ordinary" when it **generates a significant long-term benefit that extends beyond the end of the taxable year.** See INDOPCO, supra at 87-88; United States v. Mississippi Chem. Corp., 405 U.S. 298, 310, 92 S. Ct. 908 (1972); Central Tex. Sav. & Loan Association v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984); Norwest Corporation and Subsidiaries v. Commissioner, supra at 97 (and other cases cited therein). Recognizing income concomitantly with the recognition of the related expenses is a goal of our income tax system, and a proper matching is achieved when an expense is deducted in the taxable year or years in which the related income is recognized. See Newark Morning Ledger Co. v. United States, 507 U.S. 546, 565, 123 L. Ed. 2d 288, 113 S. Ct. 1670 (1993); Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1379 (11th Cir. 1982), affg. in part and remanding in part on an issue not relevant herein T.C. Memo 1981-123; Liddle v. Commissioner, 103 T.C. 285, 289 (1994), affg. 65 F.3d 329 (3d Cir. 1995).

In INDOPCO, supra, the Supreme Court set forth its most recent elucidation on the subject of capitalization when it held that an expense must be capitalized when it produces a significant long-term benefit, even when the expense does not produce a separate and distinct asset. In INDOPCO, the taxpayer was a public corporation, the two largest shareholders of which were approached in October 1977 about selling their stock in a friendly transaction. The shareholders stated they would part with their stock but only if the transaction could be structured to be tax free. Such a plan was formulated. Thereafter, the taxpayer's board of directors retained an investment banking firm to evaluate the formal offer for the stock, render a fairness opinion, and generally assist in the event of the emergence of a hostile tender offer.

The Commissioner determined [and the Tax Court agreed], that section 162(a) did not let the taxpayer deduct the direct costs that it incurred to facilitate the transaction; namely: (1) Investment banking fees and expenses and (2) legal fees and expenses related to advice given to the taxpayer and its board on their legal rights and obligations with respect to the transaction, the participation in negotiations, the preparation of documents, and the preparation of a request for a ruling from the Commissioner on the tax-free acquisition plan. Specifically, the Tax Court found that it was in the taxpayer's long-term

interest to shift ownership of its stock to the acquirer. See National Starch & Chem. Corp. v. Commissioner, 93 T.C. 67 (1989), affg. 918 F.2d 426 (3d Cir. 1990), affg. sub nom. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 112 S. Ct. 1039 (1992). Thus, the expenses were capitalizable because they were incurred incident to a shift in ownership the benefits of "'which could be expected to produce returns for many years in the future.'" Id. at 75 (quoting E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1059 (3d Cir. 1970)).

The Tax Court's holding was affirmed by the U.S. Court of Appeals for the Third Circuit and again by the Supreme Court, which, in its opinion stated:

> Although the mere presence of an incidental future benefit -- "SOME future aspect" -- may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is **incurred** is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. Indeed, the text of the Code's capitalization provision, **section** 263(a)(1), which refers to "permanent improvements or betterments," itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer.

INDOPCO, supra at 87-88(fn. ref. and citations omitted). The Supreme Court then concluded that the professional fees before them fell within the longstanding rule that "'expenses directly incurred in reorganizing or restructuring a corporate entity for the benefit of future operations are not deductible under section 162(a).'" The purpose for which these expenses are made, the Supreme Court stated, "'has to do with the corporation's operations and betterment * * * for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year'". INDOPCO, supra at 90 (quoting General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir. 1964), affg. 39 T.C. 423 (1962)).

Since the Supreme Court's decision in INDOPCO, the Tax Court has on at least four different occasions applied INDOPCO to require capitalization of acquisition-related expenditures. First, in Victory Markets, Inc. & Subs v. Commissioner, 99 T.C. 648 (1992) the Tax Court held that expenses paid by the taxpayer to a financial consulting group to provide advice and services relating to a non-hostile takeover were not currently deductible and had to be capitalized because the takeover was intended to, and would in fact, generate long-term benefits. Second, in A.E. Staley Manufacturing Co. & Subs v. Commissioner, 105 T.C. 166 (1995) rev'd and remanded 119 F.3d 482 (7th Cir. 1007), the Tax Court held that INDOPCO prevented a taxpayer from currently

deducting expenses for investment banker fees and printing costs incurred incident to a takeover because they were incurred incident to the taxpayer's change of ownership from which it derived significant long-term benefits. Then, in Norwest Corporation & Subsidiaries, 112 T.C. 89 (1999), the Tax Court held that investigatory and due diligence costs, as well as officer salaries that were both directly and indirectly related to the acquisition of a company by another company were not currently deductible and had to be capitalized because such "costs were sufficiently related to an event that produced a significant long-term benefit" and "were essential to the achievement of that benefit." Id. at 102. Finally, in American Stores Company v. Commissioner, 114 T.C. No. 27 (May 26, 2000), the Tax Court held that since certain legal fees incurred in defending against a State antitrust suit arouse out of, and were incurred in connection with, the taxpayer's acquisition of another corporation, such fees had to be capitalized and not currently deducted.

Numerous cases decided before INDOPCO also contain similar holdings. For example, in Woodward v. Commissioner, 397 U.S. 572, 90 S. Ct. 1302 (1970), the Supreme Court held that certain attorney, accountant and appraiser fees incurred by a corporation to appraise and acquire the stock of a minority shareholder were not ordinary and necessary expenses paid for the management or property held for the production of income deductible under section 212 of the Code, but instead constituted capital expenditures, to be treated as part of the cost of the stock; see also United States v. Hilton Hotels Corp., 397 U.S. 580, 90 S.Ct. 1307 (1970). Similarly, in Ellis Banking Corporation v. Commissioner, T.C. Memo. 1981-123, 41 T.C.M. (CCH) 1107 (1981), the Tax Court held that certain accounting and other expenses incurred by the taxpayer as part of its decision-making process in connection with the acquisition of a capital asset (i.e., the stock of another bank) were properly characterized as capital expenditures and not as currently deductible ordinary and necessary business expenses because such expenditures were so "inexorably tied to and such an integral part of the stock acquisition. . . ."

VI. **ANALYSIS**

A. All Legal, Professional and Accounting Fees Incurred by [redacted] Which Are Directly Related or Incidental to the Sale of [redacted]'s Stock Must Be Capitalized and Added to the Cost/Basis of [redacted]'s Stock

Distinguishing between expenses that can be deducted under section 162 and those that must be capitalized under section 263 is not always an easy task. As the Supreme Court has noted, "the cases sometimes appear difficult to harmonize," and "each case 'turns on its special facts.'" INDOPCO, supra at 86 (quoting Deputy v. Du Pont, supra at 496. After considering all the facts and circumstances, we must determine whether the legal and professional fees paid pursuant to the [redacted] Agreement and the accounting fees paid to [redacted], all of which are directly related to the Sales Transaction, are currently deductible as ordinary and necessary business expenses or are better viewed as costs associated with facilitating a capital transaction and hence subject to the capitalization rules?

In Woodward, the Supreme Court rejected a subjective "primary purpose" test in favor of the objective "origin of the claim" test used in United States v. Gilmore, 372 U.S. 39 (1963). Under the "origin of the claim" test, the nature of the transaction out of which the expenditure in controversy arose governs whether the item is a deductible expense or a capital expenditure, regardless of the motives of the payor making the payment. See Woodward v. Commissioner, supra at 578. In determining whether legal and accounting fees paid for business advice and counsel to effectuate and accomplish the sale of a corporation are capital, we look to the nature of the services performed by the adviser rather than the designation or treatment by the taxpayer. See Honodel v. Commissioner, 76 T.C. 351, 365 (1981), affg. 722 F.2d 1462 (9th Cir. 1984); Cagle v. Commissioner, 63 T.C. 86, 96 (1974), affg. 539 F.2d 409 (5th Cir. 1976).

Based upon the information provided, we conclude that since the services rendered under the [redacted] Agreement and by [redacted] (e.g., preparing memoranda for distribution to potential purchases and soliciting and evaluating proposals from prospective purchasers) were clearly performed in the process of effecting a change in corporate structure for the benefit of future operations, such amounts should not to be treated as currently deductible but must be capitalized instead. See INDOPCO, supra; Norwest Corp. & Subs. v. Commissioner, supra; Woodward v. Commissioner, supra; United States v. Hilton Hotels Corp., supra.; Ellis Banking Corporation v. Commissioner, supra

B. In the Absence of Sufficient Additional Evidence to the Contrary, the Legal Authorities Cited by the Taxpayer Do Not Currently Warrant a Bifurcation of the Selling Expenses Attributable to the Sale of [redacted] as Being Part "Ordinary" and Part "Capital."

Relying upon Leonard v. Commissioner, 94 F.3d 523 (9th Cir. 1996) revg. T.C. Memo. 1994-64. and Dye v. Commissioner 96-1 U.S.T.C. ¶ 50,404 (D.C. Kan. 1996), the taxpayer's representatives argue that a portion of the selling expenses attributable to the sale of [redacted] should be allowed as a current deduction. Although the taxpayer's reliance on these cases is well taken, the facts you have currently provided us do not suggest that such an apportionment is appropriate under the circumstances.

In Leonard, the issue addressed by the Circuit Court of Appeals for the Ninth Circuit was whether certain taxpayers who had received pre-judgment interest in settlement of an inverse condemnation suit brought against a local government that condemned and destroyed their flood-damaged homes could currently deduct certain amounts actually paid to their lawyers to obtain their share of the pre-judgment interest portion of the award or whether such amounts were capital in nature or whether some other form of apportionment could apply. In Dye, the issue was whether certain legal fees and expenses incurred by the taxpayer in a lawsuit brought against a stockbroker and his employer for fraud and mismanagement seeking compensation for professional misconduct and other punitive damages were capital in nature or currently deductible or whether some apportionment could be made between the two categories.

In both cases, the separate Courts used the "origin of the claim" test set forth in United States v. Gilmore, 372 U.S. 39, 47-48 (1963) to focus on the origin and character of the cause of action for the purposes of determining whether the recovery from that claim and the legal fees and costs associated with that claim were capital in nature or otherwise currently deductible. See Leonard, supra at 526; see also Dye, supra; see also Baylin v. United States, 43 F.3d 1451, 1453 (Fed. Cir. 1995) citing Woodward v. Commissioner, supra at 577.

Relying on United States v. Hilton Hotel, supra and Kovacs v. Commissioner, 100 T.C. 124 (1993) aff'd by unpublished disposition, 25 F.3d 1048 (6th Cir. 1993), cert. denied, 115 S.Ct. 424 (1994), the Court in Leonard stated that while attorney fees paid to establish the sales price of property were generally capital expenditures and therefore not deductible, attorney fees paid to obtain interest (which is ordinary income), were deductible. See Leonard supra at 526. Thus, to the extent the capital versus non-capital origin of the character of such fees could be determined, the Court in Leonard stated they should be apportioned between currently deductible expenses and capital expenditures. Id.

Similarly, in Dye, after applying the "origin of the claim test" the Court concluded that since the litigation in question did not reflect litigation involving the process of acquiring or disposing of assets, but was rather merely a lawsuit seeking compensatory and punitive damages, the attorney fees and expenses incurred in doing so were not capital in nature and were deductible as ordinary business expenditures. The Kansas Court, however, did leave open the possibility that a portion of such legal fees and costs might have been capital in nature, but declined to allocate any of the legal fees paid because the plaintiff had failed to present sufficient evidence establishing which portion of the expenses were actually attributable to the "process of acquisition of property." Dye supra at . quoting Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 256 (1986).

Accordingly, both Leonard and Dye permit the apportionment of attorneys fees and costs between capital expenditures and currently deductible expenses, but only if the nature and character of the underlying claim to the expenses can be determined. To be considered capital in nature under the "origin of the claim" test, the origin of the claim must involve "the process of acquisition [of property] itself," (Dye, supra at ____, quoting Woodward, supra at 577) or "of disposition of property" (Dye, supra at ____, citing Baylin, 43 F.3d at 1454). As explained in more detail in Part VI.A., above, the facts currently available indicate that all of the professional legal fees and other fees which are the subject of the proposed adjustment were paid and incurred as part of the "disposition" of [redacted]'s assets/stock (i.e., a "disposition of property"). Hence, under the "origin of the claim" test, all such fees are to be treated as 100% capital in nature. You have not provided us with any facts which would warrant a different conclusion. However, in fairness, you should ask the taxpayer to produce any additional information which might establish the non-capital character or nature of the selling expenses incurred which might result in the apportionment desired.